# Good tax policy: Tax exemptions and Economic Development

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# Scenario

- Assume a Fortune 500 business is considering locating a branch plant in Eagle, Idaho
- Assume the company's site location consultant calls the mayor of Eagle with news that the city is one of several under consideration for a new plant that expects to employ as many as 360 people.
- Assume the consultant will be in Eagle next month and would like to meet with the mayor to discuss
  1) possible plant sites in town,
  2) the quality of public services in the state, county, and city, and
  3) what, if any, package of tax abatements, incentives, and exemptions will be offered the business to locate there.
- What should the mayor do? How will home owners' react? What is the Chamber's of Commerce position?

# Portrait of a low transaction cost location decision

The good old days when businesses would:

- purchases land, hires a developer and employees
- obtain building permits, comply w/ zoning and environmental regulations
- pays taxes on property, employees, sales, & income
- little direct contact w/ public sector (p. 142)

# Portrait of a high transaction cost location decision

Institutional and political causes:

- falling transportation and communication costs
- vertical disintegration of firms & greater spatial division of labor
- rise of site consultants
- devolution
- strategic behavior by local politicians (p. 2)

May lead to lg tax breaks & use of eminent domain

## Business Location Game: Demand & Supply for Public Service X

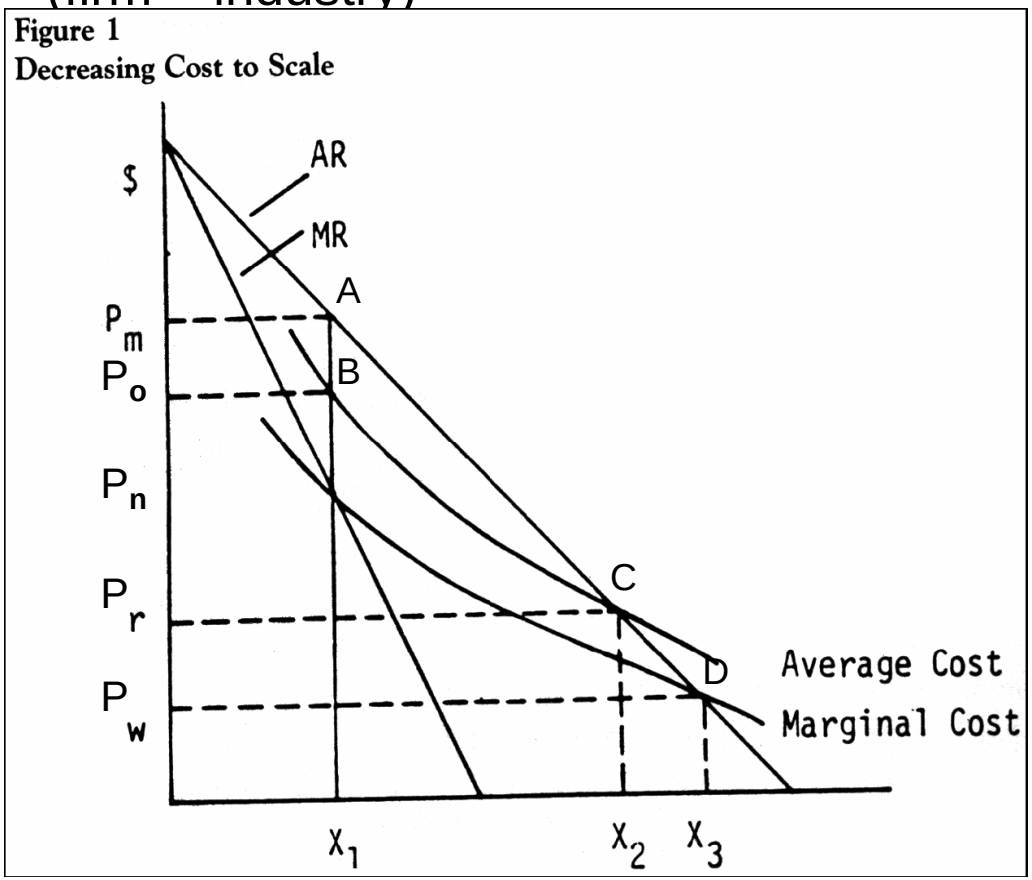
**Demand for X by Business**

- AR is the average revenue demand curve by the monopsonistic business for X
- MR is the marginal revenue demand curve of the firm for X

**Supply of X by Government**

- Average cost is the avg. supply curve of monopolistic gov't to provide X (includes variable and fixed costs)
- Marginal cost is the gov't marginal supply curve to provide X (includes only variable costs)

- Rent seeking strategies for a public service (X) with extraordinary economies of scale (firm = industry)




A. Allan Schmid, **Property, Power, and Public Choice**, 1987, p. 70

**Business Location Game: Rent from Public Service X**

**Object of the Game: Maximize Rent**

- $P_rCDP_w$ is the monopsony rent sought by the business for $X_3$

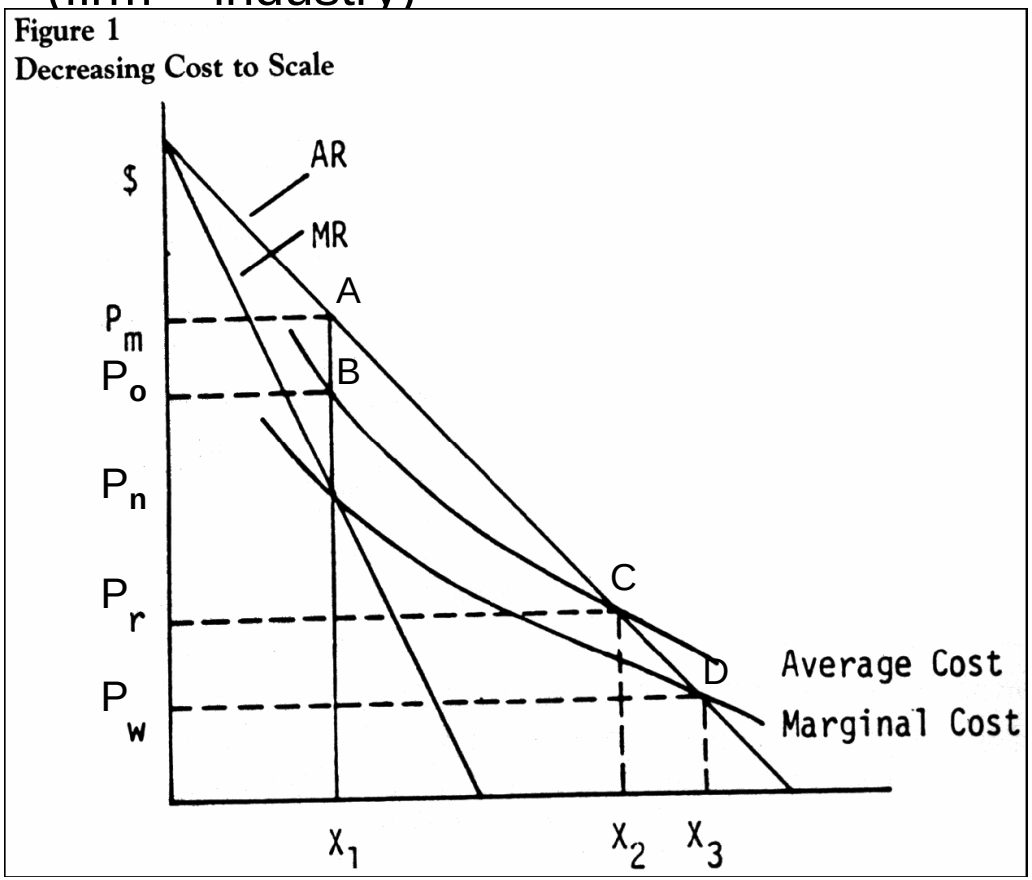
Outcome: **business wins**

- $P_r$ is the avg. price that covers both fixed & variable costs of X.

Outcome: **draw**

- $P_mABP_o$ is the monopoly rent sought by the gov't for $X_1$ Outcome: **government wins**

- Rent seeking strategies for a public service (X) with extraordinary economies of scale (firm = industry)

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# Business Location Game 1: Two Options

| Prisoner's dilemma 1 | Government (G) cooperates | Government defects (rent seeking behavior) |
|---|---|---|
| Business (B) cooperates | 1. $P_r$ good deal for all<br>G: jobs & tax base<br>B: site & public services | 2. n.a. |
| Business defects (rent seeking behavior) | 3. n.a. | 4. no deal for G &B<br>Lost social welfare esp. to distressed communities |

# Business Location Game 2: Four Options

| Prisoner's dilemma 2 | Government (G) cooperates | Government defects (rent seeking behavior) |
|---|---|---|
| Business (B) cooperates | 1. $P_r$ good deal for G&B<br>G: jobs & tax base<br>B: site & public services | 2. $P_m$ bad deal for B<br>G: jobs & tax base<br>B: poor site, no new services |
| Business defects (rent seeking behavior) | 3. $P_w$ bad deal for G<br>G: no jobs, no new taxes<br>B: site & public services | 4. no deal for G &B<br>Lost social welfare esp. to distressed communities |

# Business Location Game 3: More Options, More Players

| Prisoner's dilemma 3 | Government (G) cooperates | Government defects (rent seeking behavior) |
|---|---|---|
| Business (B) cooperates | 1. $P_r > P > P_w$ good deal for all<br>G: jobs & some tax base<br>B: site & public services<br>H: willingly cross | 2. $P_m$ bad deal for B<br>G: jobs & tax base<br>B: site, no new services<br>H: lower taxes |
| Business defects (rent seeking behavior) | 3. $P > P_w$ bad deal for G & H<br>subsidize<br>G: no jobs & no new taxes<br>B: site & public services<br>H: unwillingly cross subsidize | 4. no deal G, B, & H<br>Lost social welfare esp. to distressed communities |

households (H)

# Business Location Game 4: Even More Players

| Prisoner's dilemma 4 | Government (G) cooperates | Government defects (rent seeking behavior) |
|---|---|---|
| Business (B) cooperates | 1. $P_r > P > P_w$ good deal for all<br>G: jobs & some tax base<br>B: site & public services<br>H: unwillingly cross | 2. $P_m$ bad deal for B<br>G: jobs & tax base<br>B: site, no new services<br>H: lower taxes |
| Business defects (rent seeking behavior) | 3. $P < P_w$ bad deal for G & B<br>G: no jobs & no new taxes<br>B+: site & public services<br>H: unwillingly cross<br>-> "Farming the Programs" | 4. no deal G, B, & H<br>Lost social welfare esp. to distressed communities |

+ Perverse incentives for Business (B), Politicians (p), Site consultants (S), and Chamber of Commerce (C) -> "Farming the Programs"

# Portrait of a high transaction cost location decision 2

- CI's cost more than the revenue generated
- redirects money from infrastructure & education
- poison inter-jurisdictional relations
- contributes to sprawl
- favors large over small business
- strains local planning capacity (p. 141)
- subj. to worst kinds of cronyism and abuse

## A Firm ‘s Production Function for Output (Q)

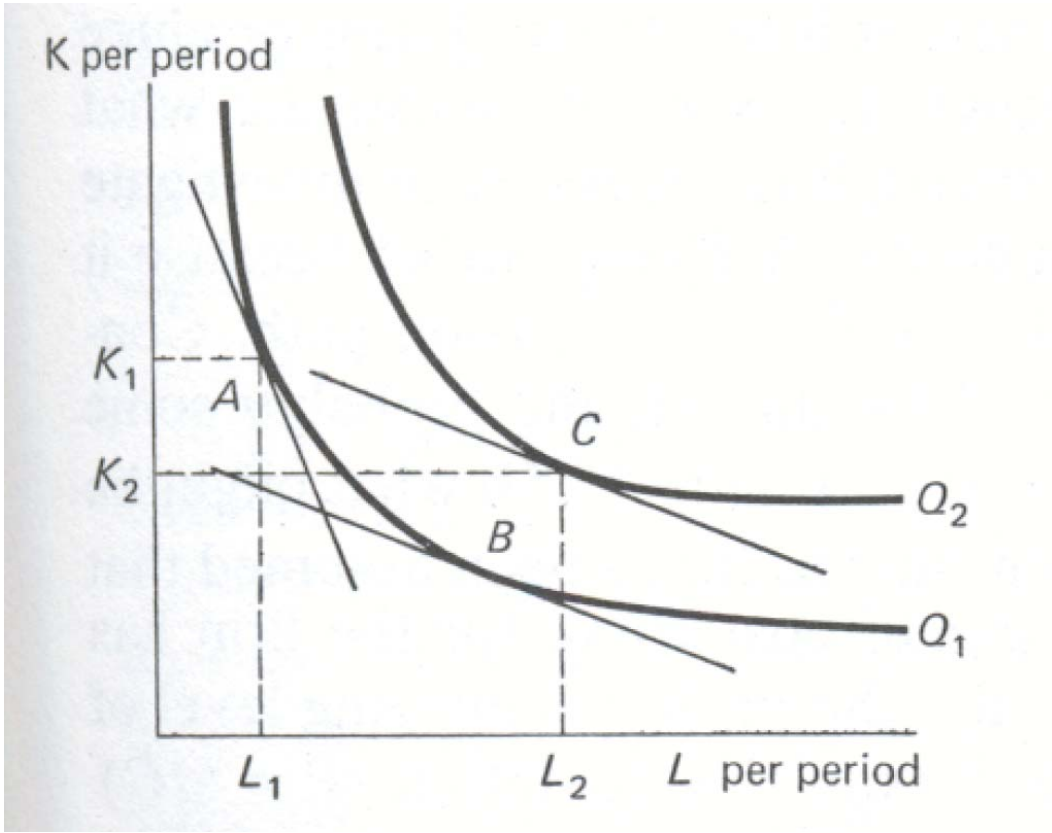
**Inputs and Output of the Firm**

- Capital (K) and labor (L) can be combined in various proportions to produce output levels $Q_1$ and $Q_2$

**Input prices**

- The ratios of alternative prices of capital to labor are the tangents to the labor and capital input combinations. These tangents determine the minimum cost of producing Q

- Capital – Labor Substitution and Output Effects from a Reduction in Wages




Walter Nicholson, **Microeconomic Theory: Principles and Extensions**, 1972 p. 339

## A Firm 's Production Function for Output (Q)

**Decrease in the price of labor**

- If the price of labor decreases relative to that of capital, then producers will substitute the cheaper labor for the more expensive capital.
- ➢ A to B: substitution effect*
- ➢ B to C: output effect

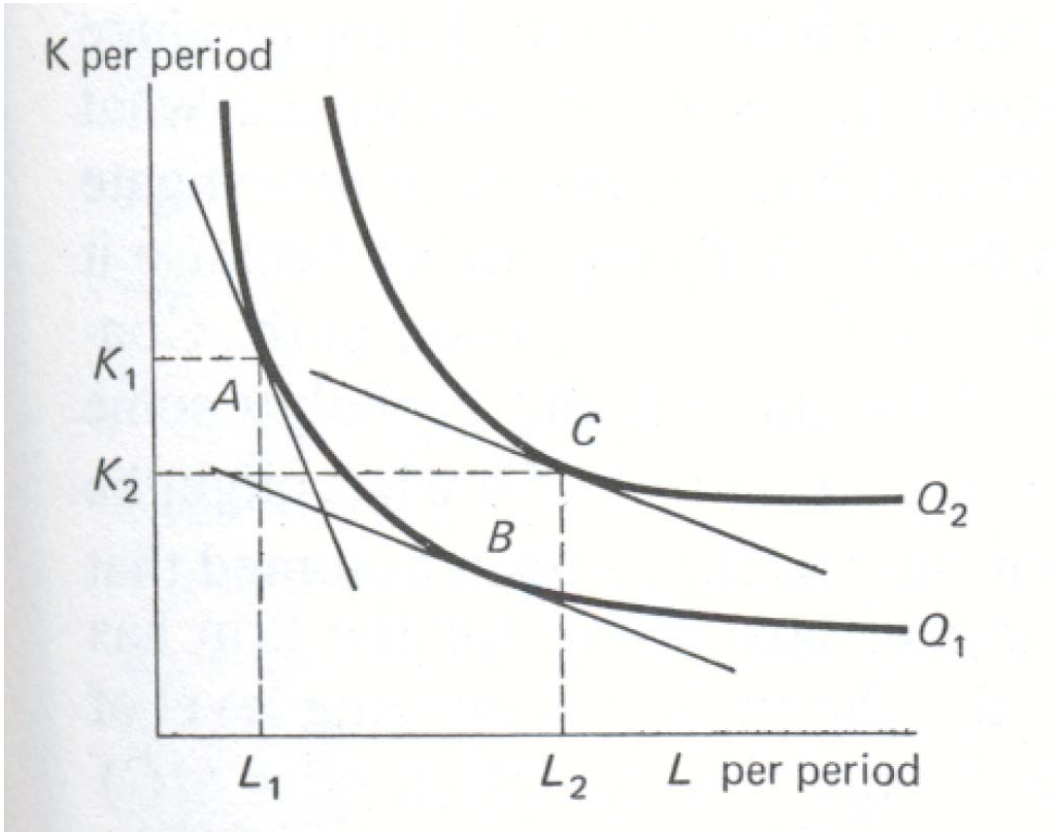
>Capital decreases from $K_1$ to $K_2$

>Labor increases from $L_1$ to $L_2$

**The moral of the story**

- If an input price decreases, more of it is used in production.
- *What happens to labor if the price of capital decreases?

- Capital – Labor Substitution and Output Effects from a Reduction in Wages

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# Gabe & Kraybill (2002)

*J. of Regional Science 42(4):703-730,*

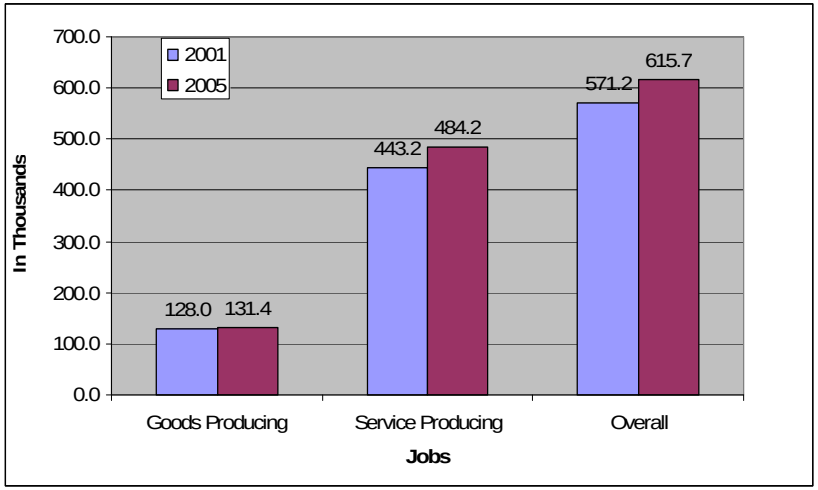
In a study of 366 Ohio firm expansions from 1993 to 1995

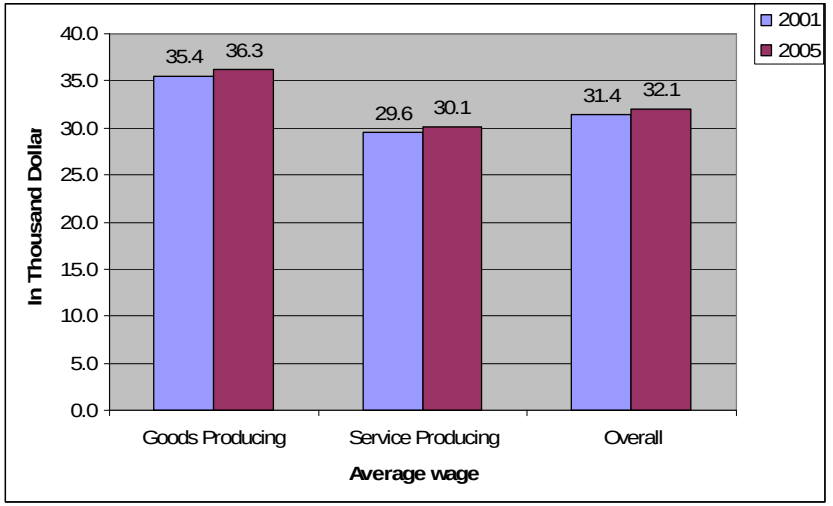
- To increase their capital incentives, firms have a reason to over announce # jobs.
- Firms that received capital incentive over-announced jobs but actually created no new jobs (see Markusen & Nesse, p. 21).
- In fact, capital incentive to firms led to fewer jobs.
- Ironically, firms with no capital incentives expanded and created new jobs.
- Reason: firm resources moved from production to seeking subsidies (farming the programs).
- Described by Krueger (1974) as rent seeking behavior.
- [Consistent w/ the substitution effect]

# A third way?

- Positive sum gains
- Focused
  - Distressed areas
  - Unemployed, underemployed local labor
- Selective subsidies w/
  - Wide spiller-overs
  - Shared public benefits

# Employment in Idaho: 2001 and 2005




**Bharathkumar A. Kulandaisamy DECOMPOSITION OF SOURCES OF CHANGES IN IDAHO WAGE STRUCTURE: 2001-2005, (August 2007)**

# **Towards a Unified Development Budget:**
## Tax Expenditure per Job with a Narrow Sales Tax Base in Idaho: 2002

- To raise sales tax revenue $150 million
- Either expand the base
  - w/ 800 jobs lost in service sector
- Or increase the rate 1 cent
  - w/ 150 jobs lost in goods sector

- Tax expenditure of a narrow sales tax base

Sales tax revenue foregone $150 million

Net jobs saved

650

Sales tax revenue foregone/ job saved

$231,000 / job

**S. Cooke, L. Stodick, & D. Holland, *Idaho Sales Tax: Increasing the Rate vs. Expanding the Base*, (February, 2006)**

# **Towards a Unified development budget:** HB306 Corporate Headquarters Incentive Act

- Min: 500 employees
- Income tax credit for capital investments
  $5 million max.
- Real property improvement tax credit
  $0.5 million max.
- Income tax credit for new jobs
  $1.5 million max.
- Property tax incentives
  $2.0 million max.
- Total incentives
  $9.0 million max.
- Incentives / job
  $18,000 / job max.

Sales tax revenue forgone:
$150 million for 650 jobs

Revealed preference for wage subsidization from HB306

$18,000 / job

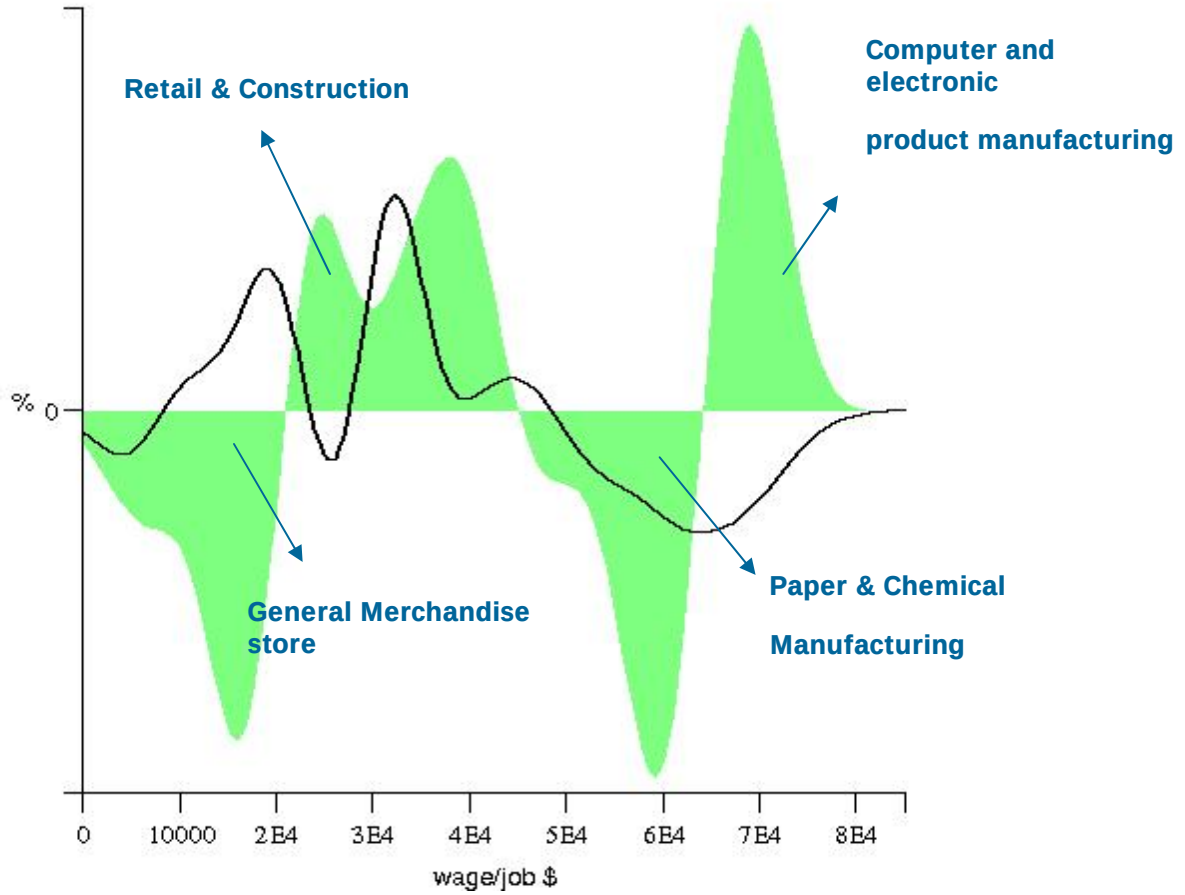
Gross jobs subsidized w/ $150 million

8,300 jobs / year

Net jobs subsidized

7,650 jobs / year
1200% increase

# Key Sectors Responsible for the Wage (shaded) and Industry Changes In Idaho's Economy:
# 2001 and 2005

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# “Where all the Difficult Contracting Issues Reside”

| **Theory of contracting** | Bounded rationality absent | Bounded rationality admitted |
|---|---|---|
| **Opportunism absent** | Bliss | General clause contracting |
| **Opportunism admitted** | Comprehensive contracting | Trilateral governance [bureaucracy] |

Williamson, O. E. *The economic institutions of capitalism : firms, markets, relational contracting.* 1985, p. 67.

# Principles of Good Contracting 1

- Written contract w/ third party enforcement
- Accountability: clear, reasonable, obvious, reduces uncertainty, reduces opportunism
- Avoid rigidity and gullibility
- Ironically, cities with the best leverage make the best deal and need them the least. (151)
- CI incentives most needed where business is least likely to want to go. (152)

Weber, R. (2007) Negotiating the Ideal Deal: Which Local Governments Have the Most Bargaining Leverage? ed. A. R. Markusen

# Principles of Good Contracting 2

- Be flexible (p. 150)
- Make investments in place and not by firm
- Performance incentives are easier to enforce and allow for more flexibility
- Devise monitoring requirements including public inspections and audits
- Performance incentives negate the need for penalties

Weber, R. (2007) Negotiating the Ideal Deal: Which Local Governments Have the Most Bargaining Leverage? ed. A. R. Markusen

# Principles of Good Contracting 3

- TIF on a pay as you go basis (cost are reimbursed)
- High income cities may prefer slow growth policies w/ exactions, and job quality requirements
- Better deals come from repeated experience
  (state- level negotiator for disadvantaged cities to offset site consultants experience)

Weber, R. (2007) Negotiating the Ideal Deal: Which Local Governments Have the Most Bargaining Leverage? ed. A. R. Markusen

# Targeted Job Creation Grant Program (NC & MN) (p. 170)

- State provides private employers $8 / hr wage supplement for 6 months to hire local workers in distressed areas ($8,300/job)
- Workforce Investment Board awards grants to firms that hire workers from disadvantaged groups
- Worker eligibility: resident of state, unemployed, exhausted unemployment insurance; or displaced by layoffs
- Job eligibility: new jobs only
- Firm eligibility: preference for firms w/ training programs and commitment to permanent jobs w/ prospect of advancement
- Clawback (70%) if an employee is hired less than 18

Schweke, W. (2007) Do Better Job Creation Subsidies Hold Real Promise for Business Incentive Reformers? ed. A. R. Markusen.